patent protection assures drug companies that if they spend hundreds of millions of dollars to develop a new drug, another drug company cannot immediately manufacture the same product. Similarly, telecommunications equipment manufacturers may be rewarded for their technological innovations with patent protection for the new products they develop. Incumbents, on the other hand, want protection not for inventing revolutionary new equipment, but rather for marketing products using other companies' innovations. That would be like protecting from competition a drug store that is retailing a new product (in addition to giving the inventor of the drug a patent). In short, it is one thing to "acknowledge the importance of protecting and encouraging incentives and innovations,"[24] and quite another to seek, as the incumbents do here, to be immunized from competition. And here, of course, Congress made clear that it did not intend that incumbents be shielded from competition when it ordered them to unbundle their network elements and to allow resale of their retail services.

Finally, the incumbents' claims that cost-based interconnection, unbundling, and collocation will chill entrants' incentives to innovate are equally misplaced. Like incumbents, entrants will have a much greater incentive to invest in infrastructure and offer advanced services if the Commission expands and clarifies its existing loop, collocation, unbundling, and resale rules. An entrant has strong incentives to deploy its own facilities even when it can lease the incumbent's facilities instead. First, and most importantly, remaining dependent on a competitor

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[24] GTE, p. 107 (quoting Commissioner Powell).

leaves the entrant open to various forms of non-price discrimination. Small reductions in service quality, delays in provisioning, and even overt conduct making the maintenance on an entrant's leased loop a lower priority than the maintenance on loops retained by the incumbent all exacerbate the entrant's competitive disadvantages. Second, leasing network elements allows the entrant to build a customer base from which it can justify investing in advanced facilities of its own. In other words, unbundled loop access actually encourages facilities-based competition.[25] Third, an entrant's incentive to deploy facilities that support advanced services is even greater than its incentive to deploy equipment supporting only voice-grade service. Data technology is evolving rapidly and, as a result, companies like AT&T have every incentive to leapfrog their competitors by, for example, developing and deploying state-of-the-art packet switches and DSLAM-type equipment.

Thus, it is clear that "[a]dvanced services are most likely to reach all Americans if incumbents are subject to unbundling obligations to permit additional competitors to provide services. Absent the essential unbundling obligations, ILECs would not have the incentive through competition to invest in the provision of advanced services."[26]

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25 See Local Competition Order, AT&T Comments at Appendix C, Affidavit of William J. Baumol, Janusz A. Ordover, Robert D. Willig ¶ 18 (filed May 16, 1996).

26 CTSI, p. 12; see also RCN, p. 20; Sprint, p. 36; Qwest, p. 71; accord KMC Telecom, p. 24.

II. THE COMMENTS BROADLY URGE THE COMMISSION, TO THE EXTENT IT ADOPTS THE SEPARATE-AFFILIATE PROPOSAL AT ALL, TO EXPAND AND STRENGTHEN THE PROPOSED SEPARATION REQUIREMENTS.

The vast majority of commenters conclude, as does AT&T, that the NPRM's proposed separation requirements are wholly insufficient to justify a finding that the ILECs' advanced services affiliates are non-ILECs under § 251(h).[27] These commenters recognize that, without substantial additional separation obligations, the advanced services affiliate will operate simply as the ILEC's alter ego, with both the incentive, and the ability, to engage in concerted anticompetitve conduct. Indeed, many commenters stress that, absent complete divestiture, an ILEC and its affiliate will never be "truly separate," and the affiliate will never act "like any other CLEC,"[28] which are the fundamental (and appropriate) guideposts the Commission set out in the NPRM.[29]

A. The Advanced Services Affiliate Described In The NPRM Is An "ILEC" Under Section 251(h).

1. <u>The proposed advanced services affiliate is an ILEC "successor or assign."</u>

The majority of commenters recognize the broad reach of § 251(h)'s ILEC definition, and urge the Commission to give the ILEC "successor or assign" provision its

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27 <u>See</u>, <u>e.g.</u>, CompTel, pp. 14-33; ALTS, pp. 18-34; Qwest, pp. 22-50; TRA, pp. 30-37; MCI WorldCom, pp. 31-57; Level 3, pp. 4-6; xDSL Networks, pp. 1012; Mindspring, pp. 12-23; Time Warner, pp. 5-6.

28 NPRM, ¶¶ 86-87.

29 <u>See</u>, <u>e.g.</u>, Level 3, pp. 4-6; MCI WorldCom, p. 41; Mindspring, p. 12; Qwest, p. 4; KMC, p. 10.

naturally expansive meaning.[30] Thus, CompTel reasons that "[a]n affiliate who obtains any advantage from its ILEC parent – including any transfer of assets, personnel or goodwill – qualifies as a 'successor or assign' under Section 251(h)(1)(ii)," and that "[w]hen an ILEC creates an affiliate with the same ownership and management, the affiliate is a 'successor.'"[31] The ILECs, of course, argue for a narrow reading of the "successor or assign" provision, claiming variously that it applies only where the affiliate "replaces" the ILEC,[32] or merges with the ILEC, or obtains ownership from the ILEC of "key" local exchange and exchange access services and facilities,[33] or receives the "entire interest of the [ILEC] and the ILEC ceases operations."[34]

At bottom, however, as the Commission already has found, there is no one definition of "successor or assign" that will apply in all legal contexts. Rather, the meaning of

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30 See, e.g., CompTel, pp. 9-11; MCI WorldCom, pp. 11-16; Network Plus, pp. 3-6; Sprint, pp. 4-7; Florida Digital Network, p. 2; Westel, p. 4; TRA, pp. 13-16; McLeodUSA, pp. 2-4.

31 CompTel, pp. 10-11 (emphasis in original). Similarly, MCI WorldCom notes that, even if the ILEC does not transfer any network elements to the affiliate (which plainly would make the affiliate an "assign)" any "affiliate that provide[s] advanced capabilities in [the ILEC's] place would still be succeeding to its role." MCI WorldCom, p. 13. See also Qwest, p. 23 ("any ILEC affiliate that owns local exchange network facilities, equipment, or capabilities is necessarily a 'successor or assign' of the ILEC under any common sense meaning of those terms").

32 Ameritech, p. 51.

33 BellSouth, p. 38-39.

34 Bell Atlantic, p. 26.

this provision must be based on the purpose of this provision and "the particular legal obligation" at issue.[35] Here, a central purpose of the "successor or assign" provision plainly is to bar ILECs from evading their obligations under § 251(c) – the section in which the ILEC definition appears – through a "corporate shell game."[36] In other words, the ILEC cannot avoid these obligations simply by foregoing local network investment (whether involving enhancements or expansion) in its own name, and instead leaving all such investment (and assets) to an affiliated entity acting as the ILEC's alter ego.

ILEC unbundling and resale obligations under § 251(c), a "cornerstone" of the Act,[37] are served only by interpreting "successor or assign" broadly, so as to ensure that movements of local exchange or exchange access functions, facilities, or services among corporate entities within the same ILEC corporate family have no effect on the application of § 251(c) to those functions, facilities, or services (and hence on their availability to all CLECs). Many commenters base their objections to the NPRM's separate affiliate proposal on its undermining of these basic § 251(c) principles. Thus, the Florida Commission expresses great

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35 NPRM, ¶ 104 & n. 202.

36 CompTel, p11. That the "successor or assign" provision was focused on attempted ILEC evasions of their § 251(c) obligations is shown by the fact that the definition applies only to those "successors or assigns" that become such <u>after</u> the Act was enacted.

37 NPRM, ¶ 73. The importance of § 251(c)'s obligations to the overall scheme of the Act cannot be overstated. The importance of these obligations is reflected, in part, by the fact that these obligations have no sunset date, and are included in one of only two sections (§ 271 being the other) placed beyond the Commission's broad forbearance authority under § 10.

concern that the NPRM proposal will encourage ILECs to transfer facilities and investments so as to evade their § 251(c) obligations, concluding "that ILECs would seek ways to move all packet-switching facilities to an unregulated affiliate[,] ... ultimately includ[ing] Signaling System 7 or its successor."[38] Similarly, the Indiana Commission and staff of the Wisconsin Commission conclude that the "NPRM provides RBOCs with an incentive to shift their most lucrative customers to packet-switched networks provided by an advanced services affiliate[, which] network can carry voice, data, and video faster and cheaper than the existing public switched network."[39]

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38 Florida, p. 6. The Indiana Commission and staff of the Wisconsin Commission similarly conclude (p. 11) that the ILEC may shift Signaling System 7 services to the unregulated affiliate. The concern that fundamental components of the current ILECs' networks, like SS7 services, might fall in the hands of an unregulated advanced services affiliate is heightened by the fact that the Commission has not attempted in the NPRM to define in any detail the types of facilities and services that may properly be controlled by the affiliate, consistent with the Act. Plainly, the distinction cannot lie between circuit-switched versus packet-switched technology, because services based on each are rapidly converging.

39 Indiana and Wisconsin, p. 11. These commenters also provide a stark example of how one ILEC, Ameritech, manipulated "ownership" of advanced services facilities to shield them (and their related services) from § 251(c). Id. at 7. Ameritech created an advanced services affiliate ("AADS"), which it identified as the owner of frame relay switches. This affiliate sells Ameritech switching services (at unknown contract rates), which Ameritech then combines with its own plant and sells back to the affiliate. The affiliate, in turn, resells these frame relay services to end users. Id. Through this "Byzantine relationship," id., Ameritech successfully has evaded its unbundling and resale obligations regarding these advanced services, claiming at various times that, because an affiliate was the "owner" of these frame relay switches, Ameritech was not obligated to allow CLECs to interconnect with them, and that, if it were called on to resell such frame relay switching services to CLECs, the resale rate would be the rate at which Ameritech paid the affiliate for these services, which Ameritech identified as its "actual cost." See Intermedia, pp. 16-19. The relationship between Ameritech and this advanced services
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Far from answering these concerns, the ILECs ignore them. The ILECs do not even suggest that their narrow interpretations of the "successor or assign" provision serve the purposes of § 251(c), and instead argue (wrongly) that such interpretations serve other interests under the Act, that is, the deployment of advanced services under § 706.[40]

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affiliate thus gave each the ability to engage in price squeezes as well as the ability to artificially inflate the costs underlying these services.

[40] See, e.g., BellSouth, pp. 21-22; GTE, pp. 34-39; Ameritech, pp. 57-58; Bell Atlantic, pp. 21-23. The ILECs no doubt will attempt to rely on a recent decision by a Connecticut district court, MCI Telecommunications v. Southern New England Telephone Co., Civ. Nos. 97cv1596, 97cv1601 (Dist. Conn. Sept. 29, 1998), in support of their cramped interpretation of the "successor or assign" provision in § 251(h). In that Connecticut decision, the district court held that an affiliate could never be considered an ILEC under § 251(h)(1), even though it admittedly was a "successor or assign," unless the affiliate also was a provider of local exchange service at the time of the Act's enactment. Id., slip op. at 29-30. This incredible conclusion – which even the ILECs have not proffered to date – effectively reads out the successor or assign provision altogether. Moreover, the decision is in direct conflict with the Non-Accounting Safeguards Order, ¶ 309, because, in the Connecticut court's view, transfers of network elements to an affiliate would not make the affiliate subject to ILEC regulation except in the unlikely event that this affiliate also was a provider of local exchange service on February 8, 1996. The district court did not even consider the reasoning of the Non-Accounting Safeguards Order, let alone refute it. This Connecticut decision is plainly wrong, and is due no deference. If the Commission nonetheless chooses to follow this decision, it is imperative that a rulemaking be initiated on the appropriate scope of the "comparable" carrier provision in § 251(h)(2), which provides an independent basis for finding that an ILEC affiliate is subject to ILEC regulation, and which expressly was left undisturbed by the Connecticut court. Cf. Indiana and Wisconsin, p. 15 ("strongly recommend[ing] that the FCC undertake a rulemaking to adopt standards for when and how section 251(h)(2) … could be applied to an advanced services affiliate").

2. The proposed advanced services affiliate is a "comparable" carrier under section 251(h)(2).

As many commenters have established,[41] even ignoring the advanced services affiliate's status as a "successor or assign," the affiliate described in the NPRM would nonetheless be subject to ILEC regulation as a "comparable" carrier under § 251(h)(2). The Commission has sweeping authority to treat "comparable" local exchange carriers as ILECs, where the carrier "occupies a position in the market within area that is comparable to the position of [the ILEC]," has "substantially replaced" the ILEC, and "such treatment is consistent with the public interest.[42]

Contrary to the suggestion of some ILECs, this comparable-carrier provision does not require that an affiliate supplant the ILEC for all services over the entire LATA before it becomes subject to ILEC regulation.[43] Indeed, such a formulation would allow an ILEC to avoid § 251(h)(2) altogether through the simple expedient of employing multiple affiliates within its LATA, each providing its own local exchange or access services within its own service area.

Instead, such ILEC treatment a comparable carrier is appropriate where an affiliate has received any exclusive benefits (such as use of the ILEC brand) owing to its corporate relationship with the ILEC (and thus is not "truly separate") (from the ILEC), and provides local telecommunications services (here, advanced services) in the same LATA as the

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41 See, e.g., CompTel, pp. 12-13; TRA, pp. 13-16; MCI WorldCom p. 16.

42 Section 251(h)(2).

43 See, e.g., Ameritech, p. 53.

ILEC. Under these circumstances, the affiliate occupies a market position "comparable" to the ILEC, because the affiliate is operating in the local telecommunications market utilizing ILEC benefits unavailable to its competitors. In addition, the affiliate has "substantially replaced" the ILEC because it is providing telecommunications services to customers that otherwise would have been served by the ILEC. Finally, such ILEC treatment for the affiliate would be fully consistent with the public interest because it furthers the market opening goals of the Act as well as deters ILECs from granting their affiliates discriminatory (and anticompetitive) benefits such that the affiliate could not be considered truly separate of the ILEC.[44]

B. The Safeguards Required By Section 272 Are Wholly Insufficient To Justify Deeming An Affiliate A Non-ILEC.

A significant majority of commenters, including the state commission commenters,[45] stress that the separation obligations under § 272 are wholly insufficient to justify deeming an affiliate a non-ILEC under § 251(h).[46] Many highlight the inability of any separation

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44 See, e.g., CompTel, p. 12 (noting that, "when the affiliate uses its parent's brand name, logo and other resources," and thus is perceived "as the ILEC's alter ego," "it plainly occupies a comparable market position to the ILEC"); cf. Illinois, p. 4 ("[I]f advanced services affiliate is the sole provider of advanced services in a given market, such affiliate may be occupying a position in the market that is comparable to that occupied by an incumbent LEC.").

45 Notably, of the eight state commissions and staff that filed comments in this proceeding, six decline to support for the NPRM's tentative conclusion that application of the proposed § 272 safeguards would justify exempting an ILEC advanced services affiliate from § 251(c).

46 See, e.g., CompTel, pp. 20-22 ("the Section 272 restrictions are woefully inadequate"); Qwest, pp. 28-35; Nextlink, pp. 6-12; MCI WorldCom, pp. 35-38.

requirements (again, short of divestiture) to prevent ILECs and their affiliates from engaging in concerted anticompetitve conduct.[47] Thus, state commissions highlight the "many opportunities for the incumbent LEC and the advanced services affiliate to work in concert to stifle competition and maximize profits,"[48] and conclude that "[a]llowing ILECs to set up unregulated affiliates appears fraught with problems."[49] Some commenters, like the Florida Commission, predict that ILECs will "devise ways to move facilities into these affiliate to escape regulation," and note that, "[e]ven if rules are put in place to discourage [anticompetitive] activities . . ., violations are very difficult to discover and police."[50]

These commenters correspondingly urge the Commission, if it does choose to sanction a separate-affiliate regime despite this likelihood of anticompetitive conduct, to broadly expand and strengthen the proposed separation obligations before allowing an ILEC affiliate to evade the unbundling and resale obligations of § 251(c).[51] For example, the Texas Commission

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47 See, e.g., MCI WorldCom, pp. 18, 23 ("It is fanciful to think that the ILEC and its affiliate would operate in a truly independent fashion."); Florida Digital Network, p. 2; Level 3, pp. 4-5; KMC, p. 10.

48 Indiana and Wisconsin, p. 8.

49 Florida, p. 6; see also id. ("Affiliate transactions rules are difficult to develop, and even more problematic to enforce."). The Minnesota Commission (p. 4) similarly concludes "that the FCC's proposals, as currently stated, tip the balance in favor of the incumbent LECs."

50 Florida, p. 6.

51 See, e.g., Texas, p. 3; MCI WorldCom, pp. 38-55; CompTel, pp. 19-31; McLeodUSA, pp. 4-6; ICG, pp. 9-16; TRA, pp. 30-37; CWI, pp. 2-9.

calls on the Commission "to create stringent guidelines, in addition to those delineated," before such an affiliate can be considered "truly separate from ILECs and . . . deserve the same treatment as other competitive carriers."[52] Similarly, e.spire concludes that "the Section 272 model is insufficient to ensure the establishment and maintenance of truly independent advance service affiliates," and emphasizes the need for "additional, more rigorous safeguards than those proposed in the NPRM."[53]

These commenters repeatedly note that § 272 was intended to permit a BOC to operate a separate interLATA affiliate in a mature, highly-competitive interLATA market, with low barriers to entry, only after a BOC had opened its local market to competition by fully satisfying the requirements of § 271.[54] The § 272 model of separation, therefore, is inadequate for the proposed advanced services affiliate, which would offer a new type of service, with substantial barriers to entry, while the ILEC still maintains monopoly control over bottleneck facilities needed by the affiliate's competitors (and prospective competitors) in that market.

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52 Texas, p. 3. Even with additional restrictions, however, the Texas Commission recognizes that there is no "guarantee that the ILEC and the separate affiliate will not strategically work together." Id.

53 e.spire, p. 8; cf. FTC Staff Economists, p. 3 (recommending that the Commission "ensure it does not adopt weak separation rules ..., [which] may thwart the development of a competitive advanced services market").

54 See, e.g., ALTS, pp. 7-9; CompTel, pp. 20-22; Time Warner, pp. 10-11; Florida Digital Network, p. 3; MCI WorldCom, pp. 19-20.

The ILECs, in contrast, claim that the section 272 obligations are too restrictive, arguing that they create inefficiencies and require duplications of effort and facilities, which will undermine investment in advanced services by not allowing ILECs "to capitalize on economies of scale and scope."[55] As shown above, supra p. 10, these claims lack factual or theoretical support. In any event, the option of employing an advanced services affiliate is purely voluntary, and nothing in the NPRM precludes an ILEC from providing advanced services fully integrated with its existing local exchange and exchange access services, taking advantage of all economies of scale and scope, but still subject to the mandated unbundling and resale obligations of § 251(c). The ILECs' real complaint thus is not with the NPRM, but with the Act itself, which is the source of their unbundling and resale obligations, and which they cannot evade by simply placing telecommunication facilities and services in the name of an affiliate.

Each of the various lesser separation standards advocated by the ILECs is inadequate under the Act for the same fundamental reason: they allow for a level of integration between the ILEC and affiliate – concerning administration, marketing, planning, employment, and property – that cannot be squared with the statutory requirement that an ILEC affiliate, to evade ILEC obligations, must operate independently from the ILEC and without advantages

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55 GTE, p. 9; see also, e.g., Bell Atlantic, p. 18 (asserting that separate affiliate requirements "will impose unnecessary costs and inefficiencies that will delay broad scale deployment" of advanced services); BellSouth, p. 13 (arguing that a separate affiliate regime will "divert resources" that will "delay substantially and curtail further ILEC deployment of advanced services") Cincinnati Bell, pp. 6-7 (affiliate proposal "does not result in an efficient use of resources").

owing to its corporate relationship with the ILEC.[56] Indeed, there is no rational basis for imposing lesser separation standards than the already inadequate standards of § 272 – given that the NPRM anticipates a competitive local market setting that does not currently exist and could only justify more separation requirements than § 272, not fewer. Significantly, not one of the state commission commenters advocates restrictions on the advanced services affiliates that fall below the baseline set by § 272, and, as discussed supra (pp. 23-24 and n.45), most call for much stricter separation standards.

C. Comments On The NPRM's Proposed Restrictions And Safeguards.

1. ILECs and their affiliates must establish compliance with the separation requirements before they may provide advanced services.

Commenters broadly call on the Commission to require that the ILECs and their advanced services affiliates, before they begin providing advanced services, establish that they have complied and will comply with all separation and disclosure obligations imposed by the Commission.[57] For example, the California Commission states that the ILECs and their affiliates should be required to submit "verifiable documentation addressing each component of the structural and transactional requirements, as well as the nondiscrimination requirements," and that "[o]perational independence should be clearly demonstrated, beginning from the planning

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56 See supra p. 18 (discussing broad scope of ILEC definition).

57 See, e.g., ALTS, p. 27; CompTel, pp. 16-18; Qwest, p. 4; Westel, p. 6 n.11; Nextlink, p. 11; KMC, p. 10; TNS, p. 6; Allegiance, p. 24; MCI WorldCom, p. 49.

stages of the affiliate's operations and the formation of the organization, continuing through the time the affiliate applies for authority to become a telecommunications provider."[58] The Indiana Commission and staff of the Wisconsin Commission similarly call on this Commission to undertake an inquiry similar to the section 271 application and review process "before granting any RBOC advanced services affiliate non-incumbent LEC status."[59]

The critical need for such review before an ILEC and affiliate are authorized to provide advanced services exempt from § 251(c) is shown by fact that, according to the Indiana Commission and others, ILECs <u>already</u> are providing advanced services through affiliates and claiming exemption from the unbundling and resale rules.[60] Plainly, given the ILECs' failed implementation of the section 272 obligations,[61] and their permissive interpretation of what

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58 California, p. 5.

59 Indiana and Wisconsin, pp. 10-11.

60 Indiana and Wisconsin, p. 7 (describing Ameritech's provision of frame relay services through an affiliate); Intermedia, pp. 16-19 (same).

61 AT&T's opening comments detailed the many ways in which ILECs have avoided and defied their section 272 obligations. AT&T, p. 11-17. Since the filing of the opening comments, the Commission has issued an order denying BellSouth Louisiana's second § 271 application, which order concludes that BellSouth continues not to satisfy the requirements of § 272. Memorandum Opinion and Order, Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in Louisiana, CC Docket No. 98-121, FCC 98-21, ¶¶ 320-360 (rel. Oct. 13, 1998). Similarly, the staff of the California Commission recently issued its final staff report in the ongoing section 271 proceedings concerning Pacific Bell that concludes that Pacific Bell still is not complying with the separate affiliate requirements in section 272 and this Commission's orders. California Public Utilities Commission Telecommunications Division Final Staff Report, <u>Pacific Bell (U 1001 C) and Pacific Bell Communications Notice of Intent to File Section 271</u>

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constitutes appropriate "separation" in the present proceeding, the Commission cannot simply rely on paper promises of compliance. This approval process, however, although necessarily rigorous, need not be onerous, and could be accomplished (with public comment) within 90 days.

2. To be truly separate, an affiliate must have substantial independent equity ownership.

A large number of commenters stress that independent equity ownership is a critical component of any truly separate advanced services affiliate.[62] Besides complete divestiture,[63] commenters suggest specific outside-ownership requirements ranging from over 20 percent to over 50 percent.[64] These commenters show that, without meaningful levels of

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Application For InterLATA Authority in California, ("California Staff Final Report") at 6, 143-155 (issued October 5, 1998).

62 See, e.g., ALTS, pp. 18-21 (recommending that in-region data affiliates have "appreciable outside ownership"); MCI WorldCom, p. 41 (advocating "a sizable amount of independent ownership, free of any ILEC influence or control"); e.spire, p. 12 (advocating "substantial percentage" of outside ownership); Covad, pp. 60-61.

63 Mindspring, p. 12 ("Only full separation through divestiture would eliminate ILEC incentives to discriminate in the Internet services market."); MGC, p. 35 (calling for "divestiture of ILECs into separate retail and wholesale organizations"); Level 3, pp. 4-6; KMC, p. 10; Qwest, pp. 38-39.

64 CompTel, p. 23 (recommending at least 40 percent independent ownership); Westel, p. 9 (same); ICG, p. 10 (recommending at least 20 percent independent ownership). As explained by CompTel and LCI, "Because its shares would be owned and publicly traded by persons and institutions expecting to earn profits from [the affiliate's] operations without regard to [its affiliation with the parent or the local operations entity], market pressures would help give the retail affiliate stronger incentives to earn a reasonable return on investments." CompTel, p. 23 (quoting Petition of LCI International

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independent ownership, the advanced services affiliate will serve simply as an alter ego of the ILEC, pursuing the best interests of the ILEC and their common parent (through price squeezes and other anticompetitive conduct) even when such conduct is against the affiliate's own corporate self-interests. Mandating outside ownership (along with guaranteed board representation for these outside owners) is necessary to create incentives within the affiliate (arising from fiduciary duties to the outside shareholders)[65] to act like a profit-maximizing CLEC, rather than only as an extension of the ILEC.[66]

3. An ILEC advanced services affiliate should be barred from providing service via resale.

Many commenters have echoed AT&T's call in its opening comments for a bar on an advanced services affiliate providing service via resale.[67] These comments note that an

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Telecom Corp. for Expedited Declaratory Rulings, CC Docket 98-5, at 17 (filed Jan. 22, 1998)).

65 See, e.g., D. Block, N. Barton, & S. Radin, The Business Judgment Rule: Fiduciary Duties of Corporate Directors, at 185 (4th ed., Prentice Hall 1994) (noting that, while a wholly-owned subsidiary must act in the best interests of the parent, a corporation with partial outside equity ownership will owe fiduciary duties to the minority shareholders).

66 For these same reasons, AT&T agrees with the recommendation of commenters stating that the pay structure for the directors, officers, and employees of the affiliate should not be tied in any way to the performance of the ILEC or its parent. MCI WorldCom, p. 41; TRA, p. 36; ICG, p. 11. Otherwise, these directors, officers, and employees will be encouraged to pursue the economic best interests of the ILEC or common parent, rather than the best interests of the affiliate.

67 See, e.g., CompTel, pp. 24-27; e.spire, pp. 18-19; ICG, pp. 14-15; Westel, pp. 7-8; KMC, p. 9.

underlying justification for exempting the ILEC from § 251(c) – to encourage ILECs to provide favorable interconnection terms available to all CLECs – would not be served through the affiliate's provision of resold ILEC services.[68] Indeed, this goal would be affirmatively disserved, because ILECs and their affiliates will inevitably choose to provision services via resale if that option exists, and the affiliate would have no incentive even to seek the best resale rates.[69]

Resale presents the ILEC and its affiliate with the opportunity to engage in a classic price squeeze, because the ILEC has bottleneck control over essential inputs to advanced telecommunications services. Indeed, the ability to resell ILEC services through an advanced services affiliate would provide an ILEC with a much more powerful means of engaging in a price squeeze than if it provided such services itself on an integrated basis. This is because retail price reductions offered by an ILEC are automatically passed on to CLECs through the whole discount provision (§ 251(c)(4)(A)), but the same price reductions through a non-ILEC affiliate would be shielded from this wholesale discount. The ILEC and affiliate working together, therefore, unlike the ILEC operating alone, could effectively engage in a price squeeze to squeeze out resale competitors, without reducing the wholesale rate available to these competitors.

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68 See CompTel, pp. 24-25; e.spire, p. 18.

69 AT&T, pp. 29-30.

Resale thus provides the affiliate with inherent and exclusive advantages in the advanced services market that are due entirely to its relationship with the ILEC. Under these circumstances, an affiliate would be "deriv[ing] unfair advantages from the incumbent LEC," and thus necessarily be deemed an ILEC under § 251(h).

D. Comments On Proposed Restrictions On Transfers Between ILECs And Their Advanced Services Affiliates.

1. Transfers of advanced services facilities will in all cases render an affiliate an "assign" of the ILEC.

The commenters overwhelmingly condemn the NPRM's proposal to allow ILECs to make "de minimis" transfers of advanced services facilities to the affiliate without the affiliate being considered an assign.[70] Indeed, many commenters object to the ILEC being allowed to transfer any assets to the advanced services affiliate, not just transfers of network elements.[71] As AT&T discussed in its initial comments,[72] the Commission currently is without regulatory forbearance authority under section 10 to create such a de minimis transfer exception to the rule previously announced in the Non-Accounting Safeguards Order.

Nor would any such de minimis transfer exception make sense as a matter of policy. Contrary to the claims of the ILECs, prohibiting the transfer of such facilities would not

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70 See, e.g., TRA, p. 34; CWI, p. 6; Network Plus, p. 5; US Xchange, p. 4; Westel, p. 12; xDSL Networks, p. 11; MCI WorldCom, p. 54; ICG, p. 13; Nextlink, pp. 9-10; KMC, pp. 4-5; Hyperion, pp. 5-6; Transwire, pp. 19-20.

71 CompTel, p. 33; e.spire, p. 20; Mindspring, p. 5.

72 AT&T, p. 33.

"penalize" ILECs that already have deployed advanced services,[73] or require unnecessary "duplication of existing assets,"[74] or result in unfairness to ILECs who bought these assets believing they would by "unencumbered by the whole panoply of new rules proposed in this NPRM."[75] There is no "penalty" in requiring that ILECs follow the dictates of § 251(c)'s unbundling and resale requirements for facilities purchased with regulated revenues to enhance the capabilities of their loops.

A blanket no-transfer rule also does not require any "duplication" of facilities. An ILEC that chooses to leave the advanced-services business, and instead "centralize [its] advanced services offering" in the affiliate,[76] can do so simply by selling its existing advanced service facilities in the market to nonaffiliates. Or an ILEC that chooses to stay in the advanced services business could deploy its affiliate's facilities elsewhere so that their service areas do not overlap.

Finally, there is no unfairness in such a no-transfer rule. ILECs have purchased and deployed advanced services facilities, using regulated revenues, in response to competition by CLECs. At the time these purchases were made, there was no reasonable basis for concluding that these facilities – enhancements to the local loop similar to existing ISDN services – would not be subject to the unbundling and resale requirements of section 251(c), as among the

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73 Ameritech, p. 57; U S WEST, p. 29.

74 SBC, p. 6; see U S WEST, p. 29.

75 GTE, p. 48.

76 BellSouth, p. 43.

features, functions, and capabilities of the local loop.[77] Moreover, the ILECs themselves recognize that a no-transfer rule would not unfairly delay or deny their affiliates' entrance into this market, as they repeatedly state that such advanced services facilities are "readily available."[78]

2. A truly separate affiliate cannot be clothed in the ILEC's brand

AT&T agrees with the numerous commentators who concluded that an advanced services affiliate should be barred from using the ILEC brand.[79] It should be axiomatic that an ILEC affiliate cannot be deemed to "function[] just like any other competitive LEC,"[80] if it comes to the market clothed in ILEC's brand.

Other than their bottleneck network facilities themselves, perhaps the most valuable asset held by any ILEC is their company name and logo. Indeed, the Commission has repeatedly cited the ILECs' strong brand recognition as a significant advantage an ILEC has in the local exchange over most other CLECs,[81] and a substantial reason why BOCs will be

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[77] That the ILECs understood that such advanced services would be subject to section 251(c) was made clear in their section 706 petitions earlier this year, which requested that this Commission forbear from applying section 251(c) to such advanced services.

[78] See, e.g., GTE, p. 43, U S WEST, pp. 7-8.

[79] See, e.g., MCI WorldCom, p. 41; CompTel, p. 34; e.spire, p. 9; Qwest, p. 4; ICG, p. 14; ALTS, p. 32-33; xDSL Networks, p. 10; McLeodUSA, p. 5; TRA, p. 35; Network Plus, p. 5; KMC, p. 7; CIX, p. 15; Supra, p. 3; US Xchange, p. 5.

[80] NPRM, ¶ 92.

[81] See Bell Atlantic/NYNEX Merger Order, ¶84 ("brand recognition and reputation in the relevant markets ... are critical assets for offering services to the mass market"); id. ¶ 132
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formidable competitors in the interLATA market once section 271 approval is granted.[82] Any transfer of this brand to the advanced services affiliate is inherently discriminatory – as no ILEC would make its brand equally available to other CLECs – and thus cannot be squared with the fundamental nondiscrimination obligation that an affiliate not receive goods, services, facilities, or information that are not equally available to nonaffiliates. Moreover, as pointed out by the Federal Trade Commission staff economists, without a ban on the affiliate's use of the ILEC's name or logo, the ILEC will have an incentive to overinvest in building its reputation, "resulting in harmful effects in both the regulated and unregulated markets," because by doing so it "enhance[s] the reputation of both it and its affiliates."[83]

The ILECs assert that their affiliates should be allowed to use the ILEC brand because the brand is not an element CLECs require to provide competitive service,[84] and because "common branding" should be encompassed within their joint marketing activities.[85] As this

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(identifying "a high value on brand name reputation for providing quality services," as one of the substantial barriers to entry in the local telecommunications markets).

82 See Ameritech Michigan Order, ¶ 15 ("[G]iven the BOCs strong brand recognition and other significant advantages from incumbency, advantages that will particularly redound in the broad-based provision of bundled local and long distance services, we expect that the BOCs will be formidable competitors in the long distance market ... .").

83 FTC Staff Economists, p. 4. The comments note further that such overinvestment in reputation amounts to improper cross subsidization, and "may be done in ways that are difficult for regulators to detect and prevent." Id.

84 BellSouth, p. 44.

85 SBC, p. 6.

Commission has made clear, however, the nondiscrimination requirement applies to every transfer between the ILEC and affiliate, not just to transfers involving network elements required to provide service.[86] Moreover, as many commenters have stressed,[87] the ILECs and advanced services affiliates must be barred from all joint marketing activities, let alone joint marketing that includes common branding.[88]

3. CLECs must be barred from favoring affiliates by providing them intellectual property rights that are not also made available to CLECs.

AT&T's opening comments stressed that, insofar as an ILEC advanced services affiliate obtains the right to access intellectual property embedded in a UNE, CLECs necessarily must be able to obtain that UNE on the same terms and conditions.[89] Similarly, the Texas Commission has noted its "concern[] about transfers of intellectual property and proprietary

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86 See Non-Accounting Safeguards Order, ¶¶ 216-218 (holding that nondiscrimination requirement "extends to any good, service, facility, or information that a BOC provides to its section 272 affiliate," is "unqualified," and will be "construe[d] ... broadly to prevent BOCs from discriminating").

87 See infra, Section II.D.4.

88 ILECs no doubt shall claim that it is unfair to bar them from making full use of their brand, which cannot be characterized as a bottleneck facility to the local exchange market, because all CLECs have an opportunity to develop their own brands and many (such as the major IXCs) themselves already have brands of enormous value. Yet the nondiscrimination requirement does not restrict the ILEC to utilize fully its brand; what it bars is the ILEC from transferring that brand to an affiliate and still having that affiliate considered "truly independent," such that it is shielded from the ILEC's statutory obligations under section 251(c). Indeed, the ILEC's brand is no different than any other ILEC asset in the sense that it was paid for by ratepayers in a regulated market.

89 AT&T, p. 37.

technology to the advanced services affiliate."[90] Since the filing of the opening comments in this proceeding, the staff of California Commission also has concluded that, when an ILEC sells a UNE to a CLEC, it should "negotiate any necessary [right to use] agreement for use of the software that parallels that in its own agreement with the vendor."[91] Moreover, the staff concluded that the ILEC "should not charge CLECs for negotiations or the [right to use] fees."[92]

Significantly, the ILECs have ignored this important issue in their comments. It is critical that the Commission, consistent with the recent California staff conclusions, make clear that nondiscrimination requirements extend to any intellectual property embedded in UNEs, and thus that ILEC affiliates cannot receive intellectual property rights with UNEs purchased from the ILEC that differ in any way from the rights provided to CLECs.

4. <u>An ILEC advanced services affiliate should not be allowed to jointly market its services with the ILEC, or to obtain discriminatory access To CPNI</u>

AT&T supports the determination of the substantial number of commenters that ILEC affiliates cannot be considered truly separate of the ILEC unless they are barred from engaging in joint marketing and are not allowed discriminatory access to the ILECs' CPNI.[93]

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90 Texas Commission, p. 4.

91 California Public Utilities Commission Telecommunications Division Final Staff Report, Pacific Bell (U 1001 C) and Pacific Bell Communications Notice of Intent to File Section 271 Application For InterLATA Authority in California, ("California Staff Final Report") at 98 (issued October 5, 1998).

92 California Staff Final Report, at 98.

93 <u>See</u>, <u>e.g.</u>, Minnesota, p. 16 (concluding that "transfers of customer accounts and CPNI, as well as joint marketing, should make an incumbent LEC's advanced services affiliate an

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As with transfers involving the ILEC's brand, it is inconceivable that any joint marketing arrangements can be entered into by the ILEC and its affiliate that are not discriminatory, because the same joint marketing opportunities cannot realistically be extended to nonaffiliated CLECs. Moreover, the joint marketing envisioned by the ILECs would involve integrating their marketing operations, as well as their product design and development, which integration cannot be squared with the requirement that the ILEC and affiliate operate independently.[94]

Some ILECs argue that because section 272 provides a limited joint-marketing exception to the general rules of independent operation and nondiscrimination, so too should this Commission craft such an exception for an advanced services affiliate.[95] As has been shown by numerous commenters, however, section 272 affiliates will operate in an entirely different

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assign"); CompTel, p. 27-28; e.spire, p. 9, 14; Qwest, p. 4; MCI WorldCom, p. 48; Westel, p. 11; see also FTC Staff Economists, pp. 4-5 (noting that the Commission "may wish to impose restrictions on joint marketing activities between the LEC and affiliate to prevent harmful discrimination").

94 SBC asserts that the following is included within "joint marketing": "common branding, discounts on mixed packages of services, joint and aggregate billing, a single point of contact for sales and service, joint customer care, customer proprietary information ('CPNI') treatment like that permitted with section 272 affiliates." SBC, p. 6. Similarly, in its recent section 271 application, BellSouth stated that, as part of its "joint marketing" with its section 272 affiliate, it will assist the affiliate in the "development and creation of packages of local and long distance services offered on an integrated basis." BellSouth Second § 271 Application, Cochran Aff. ¶ 30. Even section 272's joint marketing authority, however, does not encompass this type of "planning, design, and development" of the affiliate's offerings. Non-Accounting Safeguards Order ¶ 296.

95 SBC, p 6.

market setting than is in store for advanced services affiliates, and different restrictions on advanced services affiliates thus are justified.[96] The ILECs simply have provided no basis to extend section 272's carefully crafted exception to the otherwise applicable blanket rule of nondiscrimination (which enhances the section 272 affiliate's ability to enter the highly-competitive long distance market), into a market setting where no such exception is warranted.

Similarly, there is no justification for creating an exception to the nondiscrimination rule to allow the affiliate, while still maintaining its non-ILEC status, access to CPNI under terms or conditions different from that available to other CLECs.[97] The discriminatory transfer of CPNI from an ILEC to its advanced services affiliate makes the affiliate an ILEC within the meaning of § 251(h).[98]

Moreover, that such a transfer makes the affiliate an ILEC under § 251(h) and thus subject to ILEC regulation, is not inconsistent with the Commission's CPNI Order issued earlier this year. In that Order, the Commission held that affiliated entities of an ILEC, including section 272 affiliates, are permitted to share CPNI pursuant to section 222, despite the fact that

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96 The section 272 affiliate will compete in a mature interLATA market with established competitors only after the ILEC has established that its local exchange is fully and irreversibly opened to competition. The proposed advanced services affiliate, however, would face no long-established competitors, and would be providing service before the ILEC has opened its local exchange to competition. See comments cited supra n.53.

97 See CompTel, pp. 29-31 ("No independent provider can hope to match the advantage that could be derived from mining the ILECs' massive CPNI for advanced service customers."); MCI WorldCom, p. 48; e.spire, p. 14; Northpoint, p. 33; Westel, p. 11.

98 See supra, p. 44.

CLECs do not have the same access to this information.[99] Here the issue is not whether the ILEC is permitted to transfer CPNI to the affiliate (which, under the CPNI Order, in can), but rather whether such a transfer has the effect of transforming, under § 251(h), the affiliate from a non-ILEC into an ILEC "successor or assign" or "comparable" carrier. Thus, the ILEC is not barred from providing discriminatory CPNI access to the advanced services affiliate (as it would be with a section 272 affiliate if the nondiscrimination rules applied). Instead, such transfers are permitted, but the necessary consequence is that the affiliate (which would no longer be operating like any other CLEC) would no longer be due an exemption from § 251(c).

5. <u>All ILECs, small or large, should face the same separation requirements.</u>

A number of commenters rightly conclude that small ILECs should be subject to the same separation requirements as the large ILECs.[100] Claims to the contrary – by smaller ILECs, their trade associations, as well as the Small Business Administration – wrongly presume, first, that an ILEC cannot exert monopoly power unless it is large, and second, that an ILEC cannot profitably enter the advanced services market without being shielded from § 251(c).

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[99] AT&T believes this aspect of the CPNI Order – which reversed part of the Commission's earlier Non-Accounting Safeguards Order – was wrongly decided, and has requested its reconsideration, because it authorizes BOCs to discriminate in favor of their section 272 affiliates in violation of section 272's nondiscrimination requirements.

[100] <u>See</u>, <u>e.g.</u>, Intermedia, pp. 13-14; CWI, p. 8; Rhythms, p. 19; First Regional, pp. 19-20.